

Internal Revenue Service
memorandum

CC:TL:Br1
GLMasnik

date: JUN 24 1986

to: District Counsel, Los Angeles CC:LA
Attn: Ross W. Paulson

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your request for technical advice dated April 24, 1986, regarding the above-captioned case.

Issue:

Whether Temp. Treas. Reg. § 15a.453-1(b)(3)(ii), which prescribes the rules for reporting gain on the installment basis in situations involving the financing of the sale of property through the use of a wrap-around mortgage, are valid. 0453.00-00.

Conclusion:

The temporary regulations are legislative regulations that should not be invalidated unless unreasonable and plainly inconsistent with the statute. In this case, the regulations clearly implement the provisions of the statute and Congressional purpose by alleviating the disparity of treatment between assumption/subject to arrangements and wrap-around mortgage transactions and providing a needed degree of certainty regarding the treatment of the wrap-around arrangement.

Facts:

Petitioner is a corporation in the business of purchasing undeveloped land and reselling the land to individuals as investments. The purchaser finances the transaction through the utilization of a "wrap-around" mortgage. In the typical transaction, a purchase agreement generally calls for a 10% downpayment and the issuance of an installment obligation for the balance of the selling price. The balance is to be paid in monthly installments over a period of 10 to 15 years. Title does not pass to the purchaser until the obligation is satisfied. The petitioner services the underlying mortgage with payments received on the installment obligation. It is stipulated that in no case did the underlying mortgage exceed the basis in the property. Further, the petitioner's obligation to make payments to the holder of the underlying mortgage was in no way dependent upon

08052

whether or not the petitioner received timely payments from the purchaser. The parties stipulated that the underlying mortgage was not assumed by the purchaser nor was the property purchased "subject to" the underlying mortgage.

Discussion:

I.R.C. § 453 ^{1/} provides rules for reporting gain realized on the sale of real property on the installment basis. Under section 453(c) gain realized from transactions qualifying for the installment method is recognized in each tax year to the extent of the proportion of the payments received in that tax year which the gross profit bears to the total contract price. Generally, the purpose of section 453 is to enable the seller to recognize the profit on an installment sale over the years in which he actually receives payment, rather than in the year of the sale. See, e.g., Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948).

Under Temp. Treas. Reg. § 15a.453-1(b)(2) a ratable portion of each payment is treated as profit and the excess is return of the seller's basis in the property. An exception to that general rule is the treatment of debt encumbering the property. When encumbered property is sold and the seller is relieved of the encumbering debt, the seller has received a payment in the amount of that debt. That payment is treated entirely as a return of basis and then as profit to the extent the encumbering debt exceeds the seller's basis.

The general rule of ratable basis recovery and the special rule for encumbering debt are reflected in the formula used to calculate the gross profit ratio to be applied to each installment payment.

^{1/} Section 453 was revised by the Installment Sales Revision Act of 1980, Pub. L. 96-471, effective in the case of dispositions made after October 19, 1980 in taxable years ending after such date.

Gross Profit (contract price-adjusted basis)	x	Payment (cash received
Contact Price (contract price-indebtedness <u>not</u> in excess of basis)		+ indebtedness in excess of basis)

As can be seen, if the encumbering debt is in excess of the seller's basis, 100% of the excess will be recognized in the year of sale as gain, as well as 100% of each installment payment. Thus, the regulation, rather than providing that the gain attributable to the mortgage assumed in excess of basis be reported ratably, treats this excess as a payment in the year of sale to be recognized as gain in that year.

The adjustments in the formula for assumptions and "subject to" transactions were necessary because generally, where property is sold under an assumption or "subject to" arrangement the buyer pays the underlying mortgage himself and the seller receives, in installments, only that portion of the purchase price representing his equity in the property. The adjustments for assumption and "subject to" transactions are designed to provide a mechanism to ensure that the gain attributable to the mortgage encumbrance, (which amount is paid to the mortgagee of the underlying mortgage) is subjected to tax.

The provisions of this regulation date back to regulations promulgated under section 212(d) of the Revenue Act of 1926, as Treas. Reg. § 69, Art. 44. The regulation was held valid in Burnet v. S&L Building Corp., 288 U.S. 406 (1933).

Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) contains rules for determining the amount recognizable in situations involving wrap-around mortgages. The regulation defines a wrap-around mortgage as follows:

A "wrap-around mortgage" means an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property (wrapped indebtedness) and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness. Ordinarily, the seller will use payments received on the installment obligation to service the wrapped indebtedness.

The regulation provides that the wrapped indebtedness shall be deemed to have been taken "subject to" even though title to the property has not passed in the year of sale and even though the seller remains liable for payments on the wrapped indebtedness.

The regulation formulates two gross profit ratios to be utilized in determining gain reportable where the buyer finances the transaction utilizing a wrap-around mortgage. In the year of sale, the amount recognized with respect to cash downpayments, and the wrapped indebtedness in excess of basis, is determined in accordance with the formula discussed above, utilized for assumptions and "subject to's", as follows:

$$\frac{\text{contract price-adjusted basis}}{\text{contract price - wrapped indebtedness}} \times \text{payment (cash plus wrapped indebtedness in excess of basis)}$$

not in excess of basis

For payments on the installment obligation received in the year of sale and years subsequent to the year of sale, the following formula is applied:

$$\frac{\text{face value of wrap-around debt - seller's basis in wrap-around debt } 2/}{\text{face value of wrap-around debt}} \times \text{payment received}$$

As discussed more fully below, the regulations are designed to ensure that whether the transaction is structured as a wrap-around or a "subject to" arrangement, basically the same tax consequences will be obtained. The two gross profit ratios operate in tandem to achieve this result. The first ratio ensures (as is the case with "subject to" transactions) that basis is recovered first against the underlying debt, and that the amount by which the underlying debt (wrapped indebtedness) exceeds the seller's basis, is recognized as gain. The second gross profit ratio is designed to tax the remaining gain ratably as each payment on the installment note is made. The regulations accomplish this by reducing the numerator of the second ratio by the amount of seller's basis and the gain already recognized. The balance is the remaining gain to be recognized on the installment note payments, ratably over the term of the installment note.

^{2/} The seller's basis in the wrap-around debt is the seller's basis in the property increased by the amount of gain recognized at the time of sale and decreased by the amount of cash received at the time of sale. See Temp. Treas. Reg. §§ 15a.453-1(b)(3)(ii) and (b)(5) ex 5. In this regard cash received is actual cash payment and does not include wrapped indebtedness in excess of basis.

Temp. Treas. Reg. § 15a.453-1(b)(3)(ii), providing for treatment of wrap-around mortgages was an outgrowth of a series of cases commencing with Stonecrest v. Commissioner, 24 T.C. 659 (1955), acq. 1956-1 C.B.6. Under the formula contained in the regulations dealing with assumptions and "subject to" situations, the buyer's assumption or taking "subject to" works a disadvantage to the seller since the amount assumed in excess of basis is treated as a payment in the year of sale, thus accelerating the recognition of gain.

In a series of cases commencing with Stonecrest v. Commissioner, supra, the taxpayers were generally successful in avoiding this accelerated recognition of gain resulting under the regulation through the use of a wrap-around mortgage device. The early cases in this series, E.g., Stonecrest v. Commissioner, supra; Estate of Lamberth v. Commissioner, 31 T.C. 302 (1958), nonacq., 1959-1 C.B. 6, and United Pacific Corp. v. Commissioner, 39 T.C. 721 (1963), were generally characterized by the sale of encumbered property on the installment basis. The seller remained primarily liable on the underlying debt with no personal liability enuring to the purchaser. The seller would use the installment payment received from the purchaser to pay the underlying debt. Generally, title to the property did not pass to the purchaser until some specified future date. The court in Stonecrest, determined that the regulations requiring an adjustment to the contract price and payment in year of sale applied only to situations involving assumptions and "subject to" transactions. The court discussed the two terms as follows:

Taking property subject to a mortgage means that the buyer pays the seller for the latter's redemption interest, i.e., the difference between the amount of the mortgage debt and the total amount for which the property is being sold, but the buyer does not assume a personal obligation to pay the mortgage debt. The buyer agrees that as between him and the seller, the latter has no obligation to satisfy the mortgage debt, and that the debt is to be satisfied out of the property. Although he is not obliged to, the buyer will

ordinarily make the payments on the mortgage debt in order to protect his interest in the property. Where a buyer assumes a mortgage on property, he pays the seller for the latter's redemption interest, and in addition promises the seller to pay off the mortgage debt. This promise of the buyer can ordinarily be enforced by the mortgagee. Stonecrest v. Commissioner, 24 T.C. at 666.

The court determined that the subject transaction lacked the indicia of an assumption in view of the seller's continuing obligation to pay the underlying debt and the intent of the parties that the seller use the installment payments to pay off the underlying mortgage. Similarly, the sale was not made subject to the mortgage debt since again, the seller remained obligated to pay the debt and it was explicitly provided that the seller would continue to service the underlying debt. Further, the court found persuasive the fact that the sales price of the property was not reduced to account for the mortgage. The court noted that if property is sold subject to a mortgage, the purchase price is generally reduced to reflect the intent of the parties that the debt be imposed on the property sold. Accordingly, the court found that the regulation did not apply and therefore, the taxpayer avoided reporting as gain in the year of sale, the excess of the underlying mortgage over the basis. The court reached similar conclusions in Estate of Lamberth and United Pacific Corporation. 3/

More recently, in Hunt v. Commissioner, 80 T.C. 711 (1983), the court reaffirmed Stonecrest, Estate of Lamberth and United Pacific Corporation and clarified its position by concluding that the result obtains regardless of whether title to the land passes at the time of the sale (as in Hunt) or at some later date (as in Stonecrest, Estate of Lamberth, and United Pacific Corporation). The transaction in Hunt occurred prior to March 4, 1981, the effective date of the temporary regulations. Thus,

3/ In United Pacific, the taxpayer would not have qualified for installment payments if the "excess mortgage" was included as an amount paid since the 30 percent initial payment requirement, applicable prior to the Installment Sales Revision Act of 1980, would not have been satisfied.

Temp. Treas. Reg. § 15.453-1(b)(3)(ii) was not applicable. Since the regulation was not applicable, the court expressly declined to comment on its application. See Hunt v. Commissioner, 80 T.C. at 1143 n.14.

The Commissioner has been successful in arguing that certain transactions, although purportedly involving wrap-around mortgages, were in effect assumptions or "subject to" transactions. In these cases the court, in upholding the Commissioner's analysis, emphasized that in each case, "It is necessary to consider all the facts and the imports of all the documents executed by the parties in order to determine whether all the elements present in an assumption of a mortgage, or the taking of property subject to a mortgage, are present." See Goodman v. Commissioner, 74 T.C. 684, 713 (1980), aff'd without published opinion, 673 F.2d 1332 (7th Cir. 1981). See also, Republic Petroleum Corp. v. United States, 613 F.2d 578 (5th Cir. 1980); Voight v. Commissioner, 68 T.C. 99 (1977), aff'd 614 F.2d 94 (5th Cir. 1980); Waldren v. Commissioner, 52 T.C. 640 (1969), aff'd, 428 F.2d 1216 (5th Cir. 1970).

Thus, the Tax Court cases considering this issue commencing with Stonecrest and terminating with Hunt generally conclude that in order for the transaction to come within the purview of the regulation, the financing arrangement must constitute an assumption/subject to arrangement. Whether the arrangement constituted an assumption or "subject to" situation involved a factual determination focusing on the intent of the parties involved.

Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) was promulgated under the Installment Sales Revision Act of 1980, Pub. L. 96-471. The Act significantly revised section 453 by redesignating the provisions relating to installment sales by dealers in personal property as section 453A and provisions relating to gain or loss on the dispositions of installment obligations as section 453B. Provisions relating to the sales of real property and casual sales of personal property were deleted and replaced by new section 453. In general, new section 453 continues to provide the same method for installment reporting as was contained in section 453 prior to revision. Section 15a.453-1(b)(3)(ii), the section at issue here, contained no counterpart in the prior regulations and was intended to alleviate the disparity of treatment between assumptions and "subject to" arrangements, on one hand, and wrap-around transactions on the other, engendered by the Stonecrest line of cases.

We recommend the following arguments be advanced supporting the validity of the regulations.

1. Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) is a legislative regulation.

A legislative regulation is a regulation enacted pursuant to a specific Congressional delegation to the agency authorizing the promulgation of the rule. Congress authorizes such regulations when the statute is incomplete and Congress recognizes the need to supplement the statute and fill in the remaining gaps. See 2 Davis, Administrative Law Treatise, § 7.9, p. 49 (2d ed. 1979). Interpretative regulations are, as they pertain to the Internal Revenue Code, promulgated pursuant to the Secretary's general rulemaking authority contained in I.R.C. § 7805. These regulations are intended to interpret or construe the rules prescribed by Congress rather than issue additional rules to supplement the statute, as is the case in legislative regulations. See 2 Davis, supra, § 7.9, p. 49.

Generally, the scope of review exercised by a court is significantly narrower for legislative regulations, than is the case for interpretative regulations. Thus, legislative rules have the full force of law and are binding on the court unless arbitrary and capricious. See Joseph v. United States Civil Service Commission, 554 F.2d 1140, 1154 n.26 (D. C. Cir. 1977). In Mourning v. Family Publication Service Inc., 411 U.S. 356, 369 (1973) the Court described the scope of review for legislative regulations as follows:

Where the empowering provision of a statute states simply that the agency may make . . . such rules and regulations as may be necessary to carry out the provisions of this Act, we have held that the validity of a regulation promulgated thereunder will be sustained so long as it is reasonably related to the purposes of the enabling legislation.
[citations omitted]

Thus, it is clear, that a legislative regulation need only be a reasonable implementation of the statutory purpose to be upheld. The Tax Court has held repeatedly that a legislative regulation is entitled to greater deference than an interpretative regulation, and should be upheld unless clearly contrary to the will of Congress. See, e.g., Davidson v. Commissioner, 82 T.C. 434, 440 (1984); Wing v. Commissioner, 81 T.C. 17, 28 (1983); Feichtinger v. Commissioner, 80 T.C. 239, 247 (1983).

In the instant case section, section 453(j)(1) specifically provides that: "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section." ^{4/} The Tax Court has consistently held that statutory language similar in nature to that contained in section 453(j) connotes a delegation to the Secretary to issue legislative regulations, See, e.g., Davidson v. Commissioner, supra, (I.R.C. § 274(h)); Wing v. Commissioner, supra, (I.R.C. § 611(a)); Feichtinger v. Commissioner, supra (I.R.C. § 415(d)(1)(A)).

Thus, the legislative authorization in section 453(j) clearly designates Temp. Treas. Reg. § 15a.483-1(b)(3)(ii) legislative in nature. The regulation clearly provides a needed supplement to the statutory gap. The Supreme Court's statement in Burnet v. S&L Building Corp. regarding promulgation of the original assumption/subject to rule is equally applicable to the wrap-around mortgage rule.

Installment sales of real estate encumbered by liens give rise to many complications which Congress could not readily foresee. Accordingly, it entrusted to the Commissioner wide discretion in respect of details. Burnet v. S&L Building Corp., 288 U.S. at 414.

Similarly, the authorization contained in section 453(j) was intended to grant the Commissioner wide discretion needed to properly deal with the various financing arrangements that could be presented, one of which is the wrap-around mortgage. Accordingly, the regulation should be treated as a legislative regulation and thus should be reviewed under the "greater deference" standard generally accorded legislative regulations. ^{5/}

^{4/} This provision was originally contained in section 453(i). Pub. L. 97-34, § 202(c) redesignated section 453(i) as 453(j)

^{5/} We note that in State of Washington v. Commissioner, 77 T.C. 656 (1981), aff'd, 692 F.2d 128 (Fed. Cir. 1982), the court implied that the regulation at issue was interpretative in nature rather than legislative despite statutory authorization to promulgate regulations. See State of Washington v. Commissioner, 77 T.C. at 675. The court noted that the regulation in question considered an issue that Congress had addressed specifically in the statute and therefore, could not properly be characterized as legislative, notwithstanding the statutory authorization. As noted above, such is not the case here.

Even if the court determines that the regulation is an interpretative rather than legislative regulation, it still must be upheld if it reasonable relates to the purpose of the statute or falls within the Secretary's authority to implement the statute in a reasonable manner. See, United States v. Correll, 389 U.S. 299, 307 (1967); State of Washington v. Commissioner, 77 T.C. 656, 675 (1981), aff'd, 692 F.2d 128 (Fed. Cir. 1982). Thus, the regulation "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." Commissioner v. South Texas Lumber Co., 333 U.S. at 501. A regulation is a reasonable statutory interpretation if it harmonizes with the plain language, origin and purpose of the statute. United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982).

2. The Temporary Regulation is reasonable and consistent with Congressional Intent.

We believe there are several reasons why the temporary regulations represent a reasonable application of the statute, consistent with Congressional intent in enacting section 453.

In a wrap-around mortgage situation, as described by the temporary regulations, the seller remains liable on the underlying mortgage and will use the payments on the wrap-around mortgage to service the underlying debt. Although the seller remains liable on the underlying debt vis a vis the creditor, it is intended that the buyer will provide the funds to pay the debt. Thus, the seller's economic position in a wrap-around mortgage situation is uniquely similar to the position of a seller in a "subject to" situation, as described by the court in Stonecrest v. Commissioner, supra. As the court noted in Stonecrest, where property is taken subject to a mortgage the buyer has no obligation to satisfy the underlying mortgage but generally, it is expected that he will do so to protect his interest in the property. Thus, although the seller retains liability on the underlying mortgage, it is the buyer who is expected to service the debt. In view of the fact that the seller is in virtually the same economic position whether a wrap-around or a "subject to" arrangement is used, it would seem more than reasonable to ensure that the two transactions are, as nearly as possible, accorded similar treatment for tax purposes.

The formula in the temporary regulations ensures this equality of treatment. First, as discussed above, the primary concern underlying the temporary regulations was that under the Stonecrest line of cases, a seller using the wrap-around mortgage device could defer recognition of that portion of the gain equal to the amount by which the wrapped indebtedness exceeds the basis, and report this portion of the gain ratably over the term of the wrap-around mortgage. This is in contrast

with his counterpart in a "subject to" transaction who must recognize this portion of the gain in the year of sale. The temporary regulations rectify this anomaly by requiring, through use of the first gross profit ratio, that the wrap-around seller recognize this portion of the gain in the year of sale.

Requiring that the wrap-around seller recognize the same portion of the gain in the year of sale is clearly reasonable in view of the fact that, as discussed above, the two arrangements leave the seller in the same economic position. In the "subject to" area, the Supreme Court specifically validated this treatment of the gain reflected in the "excess mortgage" as follows:

The excess of \$77,967 under the sale agreement would never actually come into the vendor's hands, but it represents part of the admitted profits and was subject to taxation. No positive provision in the statute required that it be spread over subsequent years, and we think there was nothing illegal or oppressive in treating this as an actual payment. Burnet v. S&L Bldg. Corp., 288 U.S. at 406.

In view of the similarity in economic positions produced by the two arrangements, the Supreme Court's statement regarding the treatment of the difference between the basis and the underlying mortgage in the "subject to" area applies with equal force in the wrap-around situation.

The second gross profit ratio also operates to provide equality of treatment by ensuring (as is the case with assumptions and "subject to" transactions) that any additional gain to be reported is recognized ratably over the term of the wrap-around mortgage, and any basis in excess of the wrapped indebtedness is recovered ratably.

Application of the formula in the temporary regulations generally produces the same result for wrap-around transactions, as is accorded "subject to" transactions. For example, in situations such as example 5 contained in Temp. Treas. Reg. § 15a.453-1(b)(5), where the buyer makes no payments on the wrap-around mortgage in the year of sale, the formula will produce the same results (i.e., same amount of gain recognized in the year of sale and the same amount of gain recognized annually) as would be produced if the transaction was structured as a "subject to" and the formula contained in Temp. Treas. Reg. § 15a.453-1(b)(2) was applied. Similarly, if payments are made on the mortgage in the year of sale, the wrap-around transaction will also generate the same treatment as "subject to" transactions.

In this regard the regulation and the accompanying example is not specific regarding how a payment on the wrap-around note in the year of sale is treated. Logically, payments received at the time of sale, i.e., downpayments and mortgage in excess of basis, is computed under the first gross profit ratio. Gain to be recognized on payments on the installment note in the year of sale and all subsequent years is recognized under the second gross profit ratio. This application is mandated by the literal language of the regulations which make it clear that the second gross profit ratio is designed to measure that portion of each payment on the installment obligation which represents gain to be recognized. See Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) which provides, in part: "Therefore, . . . the gross profit ratio with respect to the wrap-around installment obligation is a fraction, the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation." (emphasis added) Thus, the gain to be recognized on all payments on the wrap-around indebtedness whether made in the year of sale or subsequently, is measured under the second gross profit ratio. Gain attributable to other payments (such as cash downpayments and wrapped indebtedness in excess of basis) is determined under the first gross profit ratio. This application of the regulations ensures that the regulation operates to equalize the treatment between wrap-around and "subject to" arrangements, as follows: 6/

For example, assume the sale price of the property is \$1,000, the mortgage is \$500 and basis is \$400. Taxpayer sells the property using a wrap-around mortgage of \$1,000 with \$200 payable on the note each year for 5 years. The taxpayer's gain is reported as follows:

6/ The example involves a situation where the mortgage is in excess of basis. However, application of the formula in this manner will generally produce the same equal treatment if the mortgage is less than, or equal to, basis.

year 1 a. Payments at Time of Sale

$$\begin{array}{rcl}
 \$ 600 (\$1000 \text{ sale price} - \$400 \text{ basis}) & & \\
 \underline{600 (\$1000 \text{ sale price} - \$400 \text{ mortgage} \\ \text{not in excess of basis})} & & \\
 \times & & \\
 \$100 (\$100 \text{ mortgage in excess of basis}) & = & \$100
 \end{array}$$

b. Payments on Note

$$\begin{array}{rcl}
 \$500 (\$1000 \text{ face value} - [400 \text{ basis} \\ + 100 \text{ gain}]) & & \\
 \underline{1000 (\text{face value})} & & \\
 \$200 & \times & = \\
 & & \$100
 \end{array}$$

TOTAL year 1 \$200

$$\begin{array}{rcl}
 \text{year 2} & \frac{\$500}{1000} \times 200 & = \\
 & & \$100
 \end{array}$$

$$\begin{array}{rcl}
 \text{year 3} & "" & \$100
 \end{array}$$

$$\begin{array}{rcl}
 \text{year 4} & "" & \$100
 \end{array}$$

$$\begin{array}{rcl}
 \text{year 5} & "" & \$100
 \end{array}$$

On the other hand, if the transaction was structured as a "subject to" arrangement with the buyer issuing an installment note for \$500 to the seller payable over 5 years, the gain would be reported as follows:

$$\begin{array}{rcl}
 \text{year 1} & \frac{\$600}{\$600} \times \$200 (\$100 \text{ mortgage in excess} \\ & & \text{of basis} + 100 \text{ cash}) = \\
 & & \$200
 \end{array}$$

$$\begin{array}{rcl}
 \text{year 2} & \frac{\$600}{\$600} \times 100 & = \\
 & & \$100
 \end{array}$$

$$\begin{array}{rcl}
 \text{year 3} & "" & \$100
 \end{array}$$

$$\begin{array}{rcl}
 \text{year 4} & "" & \$100
 \end{array}$$

$$\begin{array}{rcl}
 \text{year 5} & "" & \$100
 \end{array}$$

We note that some commentators have advocated a different application of the regulation in situations where a payment on the wrap-around note is made in the year of sale. See, e.g., J. Bronner, The Wrap-around Mortgage: Its Structures, Uses and Limitations, 12 J. Real Estate Taxation 315, 339 n.99 (1985). Nonetheless, the approach outlined above correctly applies the clear language of the regulation and ensures equalization of treatment between the wrap-around and "subject to" transaction, the primary objective of the regulation.

There are additional reasons why the regulation should be sustained. The regulations operate to foreclose an obvious abuse situation. For example, a seller with low basis property can, in anticipation of sale, encumber the property, realize cash equal to his equity immediately, and then sell the property under a wrap-around mortgage arrangement. In the absence of the temporary regulations, the taxpayer could report the gain ratably even though he has realized significant cash proceeds immediately. The temporary regulations foreclose this abuse (just as it is foreclosed for assumption/subject to arrangements) by treating the wrapped indebtedness in excess of basis as a payment in the year of sale, recognizable in the year of sale. Clearly, closing this potential "loophole" constitutes a legitimate implementation of a legislative objective. See, e.g., Estate of O'Connor v. Commissioner, 69 T.C. 165, 178 (1977).

Further, the regulation should be sustained because it interjects a degree of certainty into the wrap around/subject to area that is wholly lacking under the approach fashioned by the Tax Court. As noted above, the Tax Court has stated repeatedly that whether a transaction is to be deemed a wrap-around situation or a subject to/assumption situation is a factual determination focusing, in part, on the intent of the parties involved. See, e.g., Goodman v. Commissioner, 74 T.C. at 713.

Under the Tax Court's approach the tax consequences of the particular transaction are determined based on a factual inquiry geared to uncovering the intent of the parties. Clearly, the regulation presents a more preferable approach to administering the statute by standardizing the treatment of wrap-around transactions, thus interjecting a degree of certainty in the area for both the taxpayer and the Service. Clearly, the regulation, by alleviating the need to make a factual determination in each case in order to ascertain the tax consequences of the transaction, is reasonable in objective and implements the statute in a reasonable manner.

Support for the position that the objective of the regulations, i.e., consistency of treatment between assumptions, "subject to" arrangements and wrap-arounds, alleviation of abuse, and providing a degree of certainty in the area, can readily be found in the legislative history accompanying the Installment Sales Revision Act of 1980.

The legislative history references wrap-around mortgages in its discussion of the elimination of the provision that installment sales treatment could not be elected if the payments in the year of sale exceeded 30 percent of the selling price. The committee report expressed concern that the 30 percent test constituted a trap for the unwary and fostered devices to circumvent the rule, such as wrap-around mortgages.

Where the taxpayers are cognizant of problems of this type, the 30-percent requirement has fostered ingenious "wraparound" mortgage arrangements to qualify for installment method reporting.

Under the wraparound, the buyer does not assume the mortgage and agrees to make the payments to the seller who will continue to pay the mortgage debt. In one case, the wraparound technique was used by having the seller retain title to the property for a period of years so there would be no transfer of property "subject to" the existing mortgage. If title passes in the year of sale, the Internal Revenue Service will treat the mortgage debt in excess of basis as a payment received in the year of the sale. This issue is said to be another instance of the 30-percent initial payment rule fostering uncertainty and litigation. (S. Rep. No. 1000, 96th Cong., 2d Sess. 9 (Sept. 12, 1986), 1980-2 C.B. 484, 488 (footnotes omitted))

This excerpt is instructive because it evidences Congressional displeasure with the use of "ingenious" devices such as wrap-around mortgages to circumvent the statutory requirements, and Congressional intent that the tax consequences should be similar regardless of whether the transaction involves an assumption, a "subject to" arrangement, or a wrap-around. Further, it evidences Congressional intent to alleviate "uncertainty and litigation". As discussed in detail above, the regulation was clearly designed to implement all these Congressional objectives. Thus, there is little question that the regulation reasonably relates to the purpose of the statute and falls within the Secretary's authority to implement the statute in a reasonable manner.

Again, the Supreme Court's statement in Burnet v. S&L Building Corp., 288 U.S. at 414, considering the validity of the assumption/subject to regulations is particularly relevant to the temporary regulation at issue here. The Court stated:

Installment sales of real estate encumbered by liens give rise to many complications which Congress could not readily foresee. Accordingly, it entrusted to the Commissioner wide discretion in respect of details. And considering the practical requirements of the taxing system, we think the regulations here

challenged constitute a fair attempt to effectuate the legislative intent. They are within the broad discretion granted to the Commissioner and violate no definite provision of the statute.

Subsequently, in Commissioner v. South Texas Lumber Co., 333 U.S. at 503, the Court reaffirmed the broad discretion granted to the Commissioner to promulgate regulations under the installment reporting provisions and concluded that such regulations should not be overruled unless "clearly contrary to the will of Congress". (Emphasis added). There is no discernible reason why these statements are not equally applicable to the temporary regulations at issue here. As discussed above, the regulation represents a fair attempt to effectuate explicit legislative objectives and provide for the reasonable administration of the statute. As such, they clearly come within the broad discretion granted to the Secretary under the statute to prescribe rules. The regulation should therefore be upheld as valid.

As Mr. Paulson is aware, the issue raised in this case has also been raised in Webb v. Commissioner, T.C. Docket No. 15857-85, currently pending before the court. The reply brief, which will consider this issue, is due to be filed on June 27, 1986. We will forward a copy of the reply brief to your office as soon as it is filed.

ROBERT P. RUWE

By:

Dan Henry Lee

DAN HENRY LEE

Chief, Branch No. 1

Tax Litigation Division